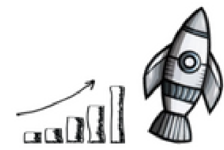

Return On Invested Capital

Another metric that we look at when evaluating a company is Return on Invested Capital (ROIC). Return on invested capital is a way that investors can determine a management team's efficiency of allocating capital. Return on Invested Capital is usually calculated by taking Net Operating Profit After Tax (NOPAT) and dividing it by Invested Capital. Net Operating After Tax is equal to Earnings Before Interest and Taxes (EBIT), also known as operating income, times one minus the tax rate.

Understanding there is a lot to unpack here, let's use an example of a theoretical company called ABC Inc. ABC Inc. has an operating income of $1,000,000, a tax rate of 30%, and invested capital of $5,000,000.

Operating Income	$ 1,000,000.00	
Tax Rate	30%	
Invested Capital	$5,000,000	
		Notes
NOPAT	$ 700,000.00	Found by multiplying $1,000,000 times .7. We used .7 because that is 1 - 30%
ROIC	14%	Found by dividing $700,000 by $5,000,000

Return on Invested Capital is very specific for assessing companies in certain industries that tend to invest a large amount of capital. If the ROIC of company XYZ Inc. was less than 14%, we know that our example of ABC Inc. is better at making a return on the capital they invest. It's also a great way to measuring business quality because it considers both the debt and equity invested in a business to produce a given level of profitability.

Why is it important to calculate Return on Invested Capital? Joel Greenblatt sums it up well in The Little Book That Still Beats the Market:

"Buying a share of a good business is better than buying a share of a bad business. One way to do this is to purchase a business that can invest its own money at high rates of return rather than purchasing a business that can only invest at lower ones. In other words, businesses that earn a high return on capital are better than businesses that earn a low return on capital."